

Volume No. 1—Policies and Procedures	<b>TOPIC NO</b>	<b>31205</b>
Function No. 30000—Fixed Asset Accounting	<b>TOPIC</b>	<b>Introduction</b>
Section No. 31200—Lease Accounting	<b>DATE</b>	December 2001

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## Overview

### Introduction

The purpose of the Lease Accounting System (LAS) is to ensure that all leased asset data is properly recorded and retained, and that all lease activity is fully and appropriately disclosed in agency and Commonwealth financial statements in accordance with generally accepted accounting principles (GAAP). GAAP regarding leases for governmental entities is set forth in the Governmental Accounting Standards Board (GASB) Statement No. 13, "Accounting for Operating Leases with Scheduled Rent Increases," and the Financial Accounting Standards Board (FASB) Statement No. 13, "Accounting for Leases," and all subsequent amendments and interpretations.

To ensure all leases are negotiated in the best interest of the Commonwealth, it is important to understand the terms of leases being considered and to make informed decisions regarding the economic value of entering the lease. Agencies must comply with both accounting and economic analysis standards set forth in the remainder of CAPP Section No. 31200—*Lease Accounting*. For financed personal property, Treasury Board Financing Program Regulations are applicable and these are given in more detail in CAPP Topic No. 31210—*Economic Analysis*.

### LAS Software

LAS is a proprietary software product purchased from Coopers and Lybrand and designed primarily to meet the FASB requirements for recording, classifying and disclosing leave activity. Specific requirements are detailed in the remaining CAPP Topics included in Section No. 31200—*Lease Accounting*.

LAS is a personal computer (PC) based system operated solely by the Departments of Accounts (DOA). Lease activity is reported to DOA using prescribed input forms. (See CAPP Topic No. 70605—*LAS Input Documents*.) The system is updated as input documents are received at DOA.

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## Definitions

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**Introduction**      The purpose of this subsection is to provide basic definitions of the key terms used throughout CAPP Section 31200—Lease Accounting.

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**Bargain Purchase Option**      (*SFAS No. 13*, para.5d) A provision allowing the lessee, at his option, to purchase the leased property for a price that is sufficiently lower than the expected fair value of the property at the date the option becomes exercisable, that exercise of the option appears, at the inception of the lease, to be reasonably assured.

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**Bargain Renewal Option**      (*SFAS No. 13*, para. 5e) A provision allowing the lessee, at his option, to renew the lease for a rental sufficiently lower than the fair rental of the property, at the date the option becomes exercisable that exercise of the option appears, at the inception of the lease, to be reasonably assured.

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**Capital Lease**      The classification to be used for any lease that meets one or more of the following criteria:

- The lease transfers ownership of the property to the lessee by the end of the lease term
- The lease contains a bargain purchase option
- The lease term is equal to 75 percent or more of the remaining estimated economic life of the leased property, unless the beginning of the lease term falls within the last 25 percent of the total economic life of the leased property, and/or
- The present value, at the beginning of the lease term, of the minimum lease payments (reduced for executory costs and profit thereon) equals or exceeds 90 percent of the fair value of the leased property to the lessor, at the inception of the lease, less any related investment tax credit retained by lessor and expected to be realized by him. This criterion does not apply if the beginning of the lease term falls within the last 25 percent of the total economic life of the leased property.

From the Lessor's standpoint, a capital lease is also known as a Direct-Financing or Sales/Type Lease.

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## Definitions, Continued

<b>CARS</b>	Commonwealth Accounting and Reporting System
<b>Contingent Rentals</b>	( <i>SFAS No. 13</i> , footnote 13) All or any portion of the stipulated rental that is contingent or rentals on which the amounts are dependent on some factor other than the passage of time.
<b>Direct Financing Lease</b>	<p>(<i>SFAS No. 13</i>, para.6bii) From the standpoint of the lessor, leases other than leveraged leases that do not give rise to manufacturer's or dealer's profit (or loss) to the lessor but that meet one or more of the 4 (four) criteria specified above (CAPITAL LEASE) as well as both of the following criteria:</p> <ul style="list-style-type: none"> <li>• Collectibility of the minimum lease payments is reasonably predictable.</li> <li>• No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.</li> </ul>
<b>End of Lease Term</b>	The date that the properties covered by a lease agreement are returned to the lessor or acquired by the lessee. This date may be fixed by the lease agreement or occur because of a termination of the lease agreement. In no case shall it extend beyond the date that a bargain purchase option becomes exercisable.
<b>Estimated Remaining Economic Life of Leased Property</b>	( <i>SFAS No. 13</i> , para.5g) The estimated remaining period during which the property is expected to be economically usable by one or more users with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease, without limitation by the lease term.
<b>Estimated Residual Value of Leased Property</b>	( <i>SFAS No. 13</i> , para. 5h) The estimated fair value of the leased property at the end of the lease term.

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## Definitions, Continued

<b>Estimated Salvage Value</b>	The amount to be deducted from the cost of an asset to determine the amount to be depreciated over its estimated useful life. This amount is usually an estimate of value when disposed of for salvage or scrap.
<b>Estimated Useful Life</b>	The estimated period during which the property is expected to be economically usable with normal repairs and maintenance, for the purpose for which it was intended.
<b>Executory Costs</b>	<p>Costs such as utilities, insurance, maintenance, and taxes that are included in the periodic payment, but are not actually for the "leasing" or rental expense of the property. If such costs are paid separately to the lessor or to another party, they are not executory costs and should not be included in the payment stream on Form LAS-3.</p> <ul style="list-style-type: none"> <li>• Each of these costs may be increased, decreased, or remain constant.</li> <li>• These costs may be estimated or obtained from the lessor.</li> </ul>
<b>Fair Rental</b>	( <i>SFAS No. 13</i> , footnote 2) The expected rental for equivalent property under similar terms and conditions.
<b>Fair Market Value of Leased Asset</b>	<p>(<i>SFAS No. 13</i>, para. 5c) The price for which the asset could be sold in an arm's-length transaction between unrelated parties. The fair market value of the leased asset may be estimated in a number of ways:</p> <ol style="list-style-type: none"> <li>1. from the lease agreement</li> <li>2. ask the lessor</li> <li>3. compare to a similar purchased asset</li> <li>4. call the tax assessor, or</li> <li>5. multiply the square foot of rental space by the estimated cost per square foot for similar assets.</li> </ol>

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## Definitions, Continued

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**Inception Date / Beginning Date** The legal inception date is the date the lease agreement commitment begins. This may be distinguished from the date that payment begins (beginning date), or fiscal inception date. When using LAS, inception date specified should be the fiscal inception date or date of first payment (beginning date).

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**Incremental Borrowing Rate** The rate that, at the inception or renewal of the lease, the lessee would have incurred if the lessee borrowed, over a similar term, the funds necessary to purchase the leased asset. For the Commonwealth, the published Prime Rate of interest is used in LAS.

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**Initial Direct Costs** (*SFAS No. 13*, para. 5m—superseded by *SFAS No. 17*, para8) Those costs incurred by the lessor that are directly associated with negotiating and consummating completed leasing transactions. Those costs include, but are not necessarily limited to, commissions, legal fees, costs of credit investigations, and costs of preparing and processing documents for new leases acquired. In addition, that portion of a salespersons' compensation, other than commissions, and the compensation of other activities described above for leases that are not consummated shall not be included in initial direct costs. No portion of supervisory and administrative expenses or other indirect expenses, such as rent and facilities costs, shall be included in initial direct costs.

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**Interest Rate Implicit in the Lease** (*SFAS No. 13*, para. 5k) The discount rate that, when applied to (i) the minimum lease payments (less executory costs and any profit thereon) and (ii) the unguaranteed residual value accruing to the benefit of the lessor, causes the aggregate present value of the lease payments at the beginning of the lease term to be equal to the fair value of the leased property to the lessor at the inception of the lease, minus any investment tax credit retained by the lessor and expected to be realized by the lessor.

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**LAS** Lease Accounting System

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## Definitions, Continued

<b>LAS Division Number</b>	The two-digit number assigned in LAS to represent the Governmental Fund Group or alternate number for Renewals for which the leased asset will be recorded under for financial reporting purposes.
<b>Lease</b>	An agreement between two parties expressing the right to use property, plant, or equipment for a stated period of time. The two parties are known as "lessor" and "lessee." The lessor is the party who has title to the "leased" property and is giving the right to use the property to another party. The lessee is the party using the property.
<b>Lease Term</b>	<p>(<i>SFAS No. 13</i>, para. 5f The fixed noncancelable term, plus</p> <ul style="list-style-type: none"> <li>• All periods covered by bargain renewal options, plus</li> <li>• All periods for which failure to renew the lease would impose a penalty sufficient to make the renewal reasonably assured, plus</li> <li>• All periods covered by ordinary renewal options during which the lessee guarantees the lessor's debt with respect to the leased property, plus</li> <li>• All periods covered by ordinary renewal portions up to the date a bargain purchase option becomes exercisable, plus</li> </ul> <p>All renewals or extensions of the lease, which are at the lessor's option. However, the lease term may not extend beyond the date a bargain purchase option becomes exercisable</p>
<b>Lessee</b>	The party using the "leased" property.
<b>Lessee Guarantee of Residual Value</b>	The portion of the estimated fair value of the leased property at the end of the lease term that is guaranteed by the lessee or by a third party related to the lessee.
<b>Lessor</b>	The party giving the right to use the "leased" property to another party.

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## Definitions, Continued

<b>Minimum Lease Payments</b>	<p>(<b>SFAS No. 13</b>, para 5j) The lessee's minimum lease payments are the payments he is obligated to make or can be required to make plus the payment called for by any bargain purchase option.</p> <p>The lessor's minimum lease payments include all payments from the lessee as above plus any guarantee of the residual value or rental payments beyond the lease term by a third party unrelated either to the lessee or lessor. If there is a bargain purchase option, only the minimum rental payments and bargain purchase option amount should be included. Otherwise, minimum lease payments include the following:</p> <ul style="list-style-type: none"> <li>• Minimum rental payments over the lease term;</li> <li>• Amount due for any guarantee of residual value by the lessee, and;</li> <li>• Any payment to be made for failure to renew or extend the lease.</li> </ul>
<b>Minimum Rental Payments</b>	<p>Those payments incurred in a leasing transaction that relate to the fixed obligation to make periodic rental payments and thus do not include such payments as contingent rentals, bargain purchase option amounts, and the like.</p>
<b>Net Minimum Lease Payments</b>	<p>All payments included in minimum lease payments, less executory costs (and related profit thereon), included therein.</p>
<b>Noncancelable Lease Term</b>	<p>(<i>SFAS No. 13</i>, para. 5f) The time period in which the lease is not cancelable. A lease that is cancelable (i) only upon the occurrence of some remote contingency (ii) only with the permission of the lessor, (iii) only if the lessee will pay a penalty of an amount such that continuation of the lease appears, at inception, reasonably assured shall be considered "noncancelable."</p>
<b>Operating Lease</b>	<p>(<i>SFAS No. 13</i>, para. 6aii and 6biv) The classification of a lease that does not meet any of the 4 (four) criteria for a capital lease (lessee) or that does not meet all of the criteria of a sales type, direct financing or leveraged lease (lessor).</p>

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## Definitions, Continued

<b>Present Value</b>	The present value is the equivalent value now of a series of future payments, discounted back to the present date at a specific rate of interest.
<b>Sales Type Lease</b>	The classification of a lease from the standpoint of the lessor that meets the criteria of a direct financing lease (see DIRECT FINANCING LEASE) and additionally gives rise to manufacturer's or dealer's profit (or loss) to the lessor.
<b>Sublease</b>	A lease of property granted by a lessee. To sublet or rent under a sublease agreement between a lessee and a third party, i.e., property is owned by a lessor, who rents to a lessee, who subleases to a third party.
<b>Third-Party Guarantee of Residual Value</b>	A guarantee of all or a portion of the estimated residual value by a third party unrelated to either the lessee or lessor.
<b>Transfer of Ownership</b>	Title (ownership) to the property passes from the lessor to the lessee.
<b>Total Economic Life of Leased Property</b>	The total estimated period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended. This period is equal to the estimated economic or useful life of the leased property (see ESTIMATED USEFUL LIFE ) if the lease property is new.
<b>Unguaranteed Residual Value</b>	( <i>SFAS No. 13</i> , para. 5i): The estimated fair value of the leased property at the end of the lease term exclusive of any portion guaranteed by the lessee or by a third party unrelated to the lessor.

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## Procedures

**Accounting For and Controlling Leased Assets** To ensure consistency and accuracy in accounting for and controlling leased assets, follow these guidelines:



<b>Step</b>	<b>Action</b>
1	Assign a person and a backup to be the agency's LAS representative, giving them specific organizational responsibility for lease recording and accounting within the agency. The agency fiscal officer may also delegate authority to approve LAS transactions by adding the LAS representative to the agency's FAACS/LAS signature card.
2	Gather and record all leases in a central location under the assigned person and determine how the leases will be filed.
3	Number and control all leases in a consistent manner. Maintain a log with appropriate lease reference information including the Lease Number/Division Number, permitting the agency and its auditors to quickly locate lease agreements.
4	File copies of the LAS reports with agency copies of the corresponding LAS input documents, while keeping the original LAS reports as a complete package for quick review of all leases recorded in the system.

**Procurement** Computer equipment leases must comply with all the guidelines issued by the Department of Information Technology. Real property leases such as land and buildings must comply with guidelines issued by the Department of General Services (DGS) and should be approved by the Bureau of Real Property Management of DGS. Once entered into, all leases must be recorded in the Lease Accounting System by submitting appropriate input documents to DOA. (See CAPP Topic No. 70605—*LAS Input Documents*.)

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## DOA Contact

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## Subject Cross References

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**References**      CAPP Topic No. 31210—*Economic Analysis*  
  
CAPP Topic No. 70605—*LAS Input Documents*

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